The Conference Board

Economic and Business Environment Program

World Economic Monitor

Volume 4, Number 4 Fall 1989

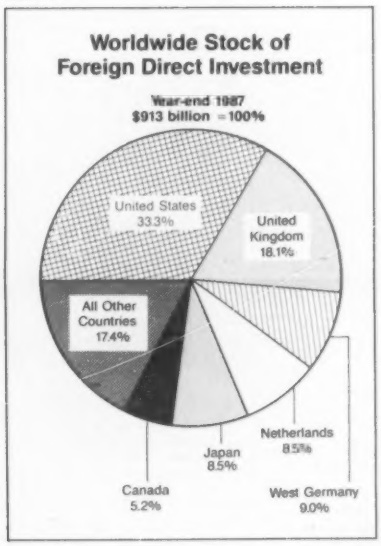
THE CHANGING PATTERN OF FOREIGN DIRECT INVESTMENT

The 1980s have witnessed extremely rapid growth in worldwide foreign direct investment. According to estimates by the International Monetary Fund and other international organizations, the annual flow of such investment rose from $55 billion in 1980 to $137 billion in 1987, or two-and-a-half times. By comparison, over the same period world output grew by approximately 20 percent and the volume of world trade by 28 percent. According to these same estimates, at year-end 1987 the *stock* of global foreign direct investment totaled $913 billion (Chart 1) or slightly more than that year's gross national product of West Germany.

Direct Investment and Multinationals

The heightened direct investment activity of the 1980s has altered the distribution of the world's leading multinational companies (MNCs). The United States—which in the early 1970s had accounted for over half of the world's largest industrial corporations—saw its role change from the leading source of MNC activity to the largest recipient. Outward investment by the United Kingdom began to exceed that of the U.S. in the first half of the 1980s. But by the middle of the decade, Japan had taken the lead as the largest source of direct investment abroad.

Chart 1



Sources: Japan External Trade Organization; Hypo Bank

Foreign direct investment by corporations based in developing countries amounted to less than 3 percent of the world's stock of overseas investment by the middle of the decade. Although the number of developing-country MNCs is fairly substantial, most of these firms tend to be small. Seventeen of them have sales exceeding $1 billion, however, and ten of these are based in three countries—Korea (six), Brazil (two), and Mexico (two). A few oil-exporting countries with interests in petroleum refining and marketing also contain fairly large MNCs.

According to a recent report by the United Nations Centre on Transnational Corporations, the world's 600 largest multinationals—each of which has annual sales in excess of $1 billion—create one-fifth of the world's total value-added in manufacturing and agriculture. While it is somewhat misleading to compare the activities of MNCs to world economic activity in general, the U.N. notes that many multinational corporations are bigger than the economies of several countries.

However, the U.N. report also lays to rest the old assumption that all MNCs are, by definition, big and powerful, and likely to abuse that power. Although Japan and the United Kingdom are among the world's largest exporters of capital, 23 percent of Japanese MNCs in 1984 employed fewer than 300 people. And in the early 1980s, 78 percent of British firms with overseas investments employed fewer than 500 people. Of course, these smaller MNCs, the U.N. notes, "appear to be less internationally diversified than the larger ones. These firms tend to have fewer affiliates abroad than the larger MNCs. When they do invest abroad they tend to do so in only one or a small number of countries."

Copyright © 1989 by The Conference Board, Inc.

WORLD ECONOMIC MONITOR (ISSN 0896-2545) is published quarterly by The Conference Board, Inc., 845 Third Avenue, New York, N.Y. 10022. Printed in New York, N.Y. Second-Class Postage at New York, N.Y. POSTMASTER: Send address changes to The Conference Board, 845 Third Avenue, New York, N.Y. 10022.

Foreign Direct Investment in the United States

The two most visible features of recent foreign direct investment activity or cross-border acquisitions are those made *in* the United States, on the one hand, and those made *by* European countries, particularly the United Kingdom, on the other. (There is of course considerable overlap between the two.) In 1988, an estimated 64 percent of the dollar amount (and over half the number) of international acquisitions took place in North America. Of the investing countries, the United Kingdom accounted for 38 percent of both the value and the number of transactions (Table 1).

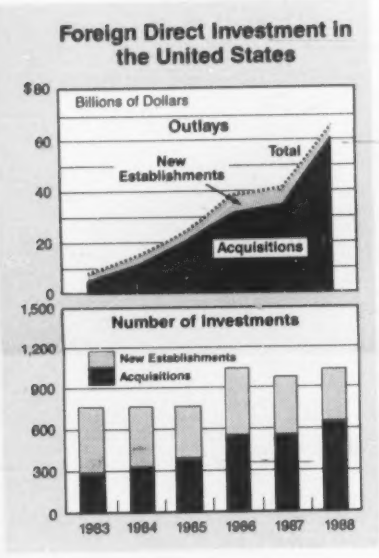
Table 1

International Mergers and Acquisitions, 1988

Outward investment			*Inward investment*	
$ bill.	*Number*		*$ bill.*	*Number*
20.1	550	North America	75.5	1,246
44.5	884	United Kingdom	17.7	226
19.4	422	Other EC	13.7	527
11.0	81	Japan	–	–
23.4	389	Rest of World	11.5	327
118.4	2,326	World total	118.4	2,326

Sources: KPMG; Hypo Bank

Chart 2



Source: Department of Commerce.

Spending by foreigners to acquire or establish U.S. business enterprises reached record levels last year, up 60 percent over 1987 and four times the amount spent as recently as 1984 (Chart 2). Apart from brisk economic growth in the United States, which made U.S. companies increasingly attractive to foreign investors; and continued corporate restructuring, which provided investment opportunities, the 1988 increase in direct investment here also reflected concern about possible U.S. measures to restrict foreign merger and acquisition activity. Concern was heightened by passage of the 1988 trade bill, which included an amendment giving the President power to block foreign acquisitions on grounds of national security. Nevertheless, the *number* of new foreign investments last year was barely higher than in 1987, and actually smaller than in 1986. This simply means that, as in the domestic economy, individual deals have become very much larger.

The biggest foreign acquisition in 1988 was $6.5 billion. A $5.2 billion purchase took second place, and the ten largest had a combined value of almost $29 billion. Only 60 percent of last year's transactions involved outlays of under $10 million, compared to over 80 percent in 1981 and 1982. Nevertheless, foreign acquisitions in 1988 continued to be dwarfed by mergers and acquisitions among U.S. firms, which were two-and-a-half times as large in value and over six times as many in number.

While it can be argued that the cumulative effect of dollar depreciation against other major currencies since the mid-1980s may have encouraged foreign acquisitions in the U.S., exchange-rate considerations may play only a small part in the decision to enter or expand in the U.S. market. Certainly, the dollar *appreciation* of the early 1980s did not deter foreign investors from entering the United States.

Moreover, while a cheaper dollar lowers the cost of acquiring a U.S. firm, it also lowers the foreign-currency value of earnings in the U.S. Because of the relatively sharp decline in the dollar since early 1985, foreign firms may well have had an incentive to shift more of their operations to the United States so that both their expenses and their sales would be denominated in dollars. This would help them to avoid increasing prices to U.S. consumers.

The U.S. Direct Investment Position

There has been much discussion lately of the United States as an international debtor—according to some versions, with a foreign debt larger than that of Brazil or Mexico. It would be more accurate to say that the U.S. international investment position has turned negative. Within this total picture, however, the U.S. position on direct investment appears to be more or less in balance (Chart 3) and may even be understated.

The direct investment estimates—both inward and outward investment—are carried at book value and therefore largely reflect prices at the time of the investment rather than current values. As a result, both the inward and the outward investment positions are understated in relation to current market value. The understatement of the stock of U.S. direct investment abroad is probably significantly larger, because it is more "mature." According to a recent State Department estimate, valuing this investment at its current market price might add as much as $600 billion—thereby lowering the U.S. "debtor" position.

Mergers and Acquisitions in Europe: Anticipating 1992

Of equal, and perhaps even greater, significance has been the evolution of cross-border marriages among European corporations in anticipation of the emergence of a single, borderless European market after 1992. French acquisitions in the United Kingdom, for example, rose from $840 million in 1987 to $1.3 billion last year. While substantially lower to start with, British acquisitions in France jumped from about $150 million in 1987 to $850 million in 1988. The pace has picked up in other European countries as well.

This activity is producing a new kind of hybrid, in which companies of different nationalities unite to form a new European multinational, forsaking their national identities in the process. While intra-European corporate alliances are not a new phenomenon, national rivalries often prevented them from succeeding. This time around, European firms are conscious of the need to create corporate entities that can compete in the new, enlarged Europe, as well as on a global scale.

Chart 3

Source: U.S. Department of Commerce

It is interesting to note that the most publicized European merger to date (Sweden's Asea and Switzerland's Brown Boveri) involved two companies not domiciled in the European Community, but in the smaller European Free Trade Association (EFTA). As the new company's director of information has noted, "Firms in the EFTA area can no longer afford to wait for economic and political integration. They have to build up their own all-European home market with their own entrepreneurial strategies." Thus, he added, the new corporate giant "links the two EFTA halves of Scandinavia and Switzerland/Austria and provides a bridge from EFTA into the EC."

Nevertheless, these transitions may not always be smooth. The announcement in mid-September that Belgium's largest and the Netherlands' third largest bank had abandoned their plans for a full merger was generally seen as illustrative of some of the cultural and technical obstacles—including differences in company law and in fiscal and regulatory provisions—that need to be tackled if Europe is to become a truly integrated marketplace.

Assessing the Data

There are some pitfalls in comparing national direct investment statistics, since different countries apply different criteria in defining and hence recording direct investment (Table 2). The United States considers such investment as any holding that controls "directly or indirectly, 10 percent or more of the voting securities of an incorporated foreign business enterprise or an equivalent interest in an unincorporated foreign business enterprise." By contrast, in German balance-of-payments accounting, the critical threshold is a minimum holding of 25 percent; however, holdings in companies other than limited liability firms are considered direct investment regardless of the degree of ownership.

For most countries, direct investment statistics also include transactions that do not involve cross-border movements of capital, such as the reinvestment of profits

Table 2
Minimum Foreign Holding Required For "Direct Investment" Classification

	Inward investment	*Outward investment*
Australia	10%	10%
Austria	5	*
Canada	10	10
France	20	20
Germany	25	25
Japan	*	10
Portugal	11	11
Spain	20	20
United Kingdom	20	20
United States	10	10

* Based on other criteria

Source: OECD

earned abroad. In other words, a parent's decision not to repatriate a subsidiary's earnings is considered a direct foreign investment, at least for statistical purposes.

Even more important, the existing data on the *stock* of foreign direct investment, large as this investment may seem, underestimate the importance of foreign-owned firms in national economies, since foreign equity is only a fraction of the total assets and liabilities of these firms. Other sources of financing include borrowing from banks, security issues, trade credits, and the equity position of host-country residents.

There is of course no hard-and-fast line between an active investment, where the foreign owner exerts significant or total control over the operations of a local firm, and a passive investment, where the owner has little or no involvement with management. In some cases, with even less than 10 percent ownership of an affiliate, a corporation can exert effective control over its operations, particularly when it supplies a key input, such a technology or other know-how. In other cases, companies with substantially larger equity stakes may in fact have little control and may treat their investment much in the manner of a portfolio investment.

The Conference Board
845 Third Avenue, New York, N.Y. 10022 / 759-0900
1755 Massachusetts Avenue, N.W., Suite 312, Washington, D.C. 20036
255 Smyth Road, Ottawa, Ontario, K1H-8M7, Canada
Avenue Louise, 207-Bte 5; B-1050 Brussels, Belgium

Prepared by John Hein, Economic and Business Environment Program. Reproduction permissible with full citation to The Conference Board as source. Published quarterly at 845 Third Avenue, New York, New York 10022.